Latin America: From Recovery To Slowdown

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Key Points

- Latin America has had a disappointing economic performance after a very strong recovery from the Great Recession.
- Weak commodity prices means that Latin American economies will grow at more moderate rates in the near future, but macroeconomic policies need to be consistent with this new scenario.
- Institutional weaknesses and the high level of inequality in Latin America are some of the challenges to be overcome in order to stimulate economic growth in the region.
- Argentina and Venezuela still suffer from the macroeconomic instability that was central to Latin America's history of stagnation with high inflation.

Introduction

Latin America's recent economic performance has been disappointing. After having a very strong recovery from the Great Recession, which was unprecedented as documented in De Gregorio (2014), the region has experienced a severe slowdown. Growth during 2014 was significantly below expectations, and 2015 has been dim.

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The extent of the rapid recovery and the ensuing slowdown is shown in Figure 1. Per capita GDP is normalized to 100 in 2008, just at the eve of the crisis. With the exception of Mexico, (which for obvious reasons was more affected by the crisis in the US), and of Venezuela, (that is severely contracting due to years of economic mismanagement and a strong dependence on oil), recovery during 2010 was quite solid. After strong growth in 2010, Brazil experienced a significant slowdown. A strong recovery continued in Chile, Colombia and Peru, but 2014 was a bad year, with the only exception being Colombia, where the deceleration seems to be staring in 2015. Prospects for this year are not bright since among the largest seven economies of the region (LAC7), a contraction of output is expected in Argentina, Brazil and Venezuela, while in Chile, Colombia, Mexico and Peru, growth would be about 3 percent.

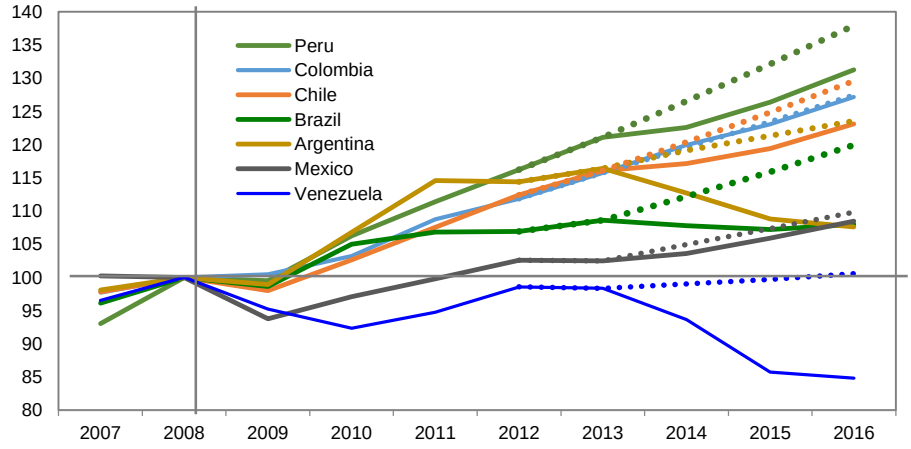
The dotted lines in Figure 1 show the IMF's April 2013 forecast for the path of per-capita GDP. Clearly, performance and current prospects toward next year are worse than expected almost two years ago, but there is also heterogeneity in the extent of the growth surprises. Except for Colombia that keeps growing, and Mexico that has had low growth expectations, for the rest of the countries the gap between current trends and expectations are significant. Most notably for Argentina, Brazil and Venezuela.

In the past, whenever there were slowdowns, the external environment was usually the reason. This time, it is not quite that case. International financial conditions have been favourable, and the most significant decline in commodity prices started in the second half of last year, while the declines in forecasts started early in the year. With hindsight, the actual deceleration started in the second half of 2013. But the slowdown is much more related to the business cycle and to long-term productivity growth than to external conditions.

In this paper I want to discuss the sources of the deceleration and the implications for the future in the region. In the next section I discuss briefly the most relevant aspects of the global economy for the region, namely commodity prices and the prospects of tightening monetary policy in the US. Then, in section 3, I will discuss the sources of the deceleration. First of all, I emphasize the role of the business cycle, by which after a rapid recovery, it

is normal to expect a slowdown. It is important to note that Latin America, and most emerging market economies, were not used to such a fast recovery, which makes particularly difficult to forecast turning points in the business cycle. There is also uncertainty about long-term growth potential, and forecasts have been optimistic, reproducing past good performance as a permanent feature. In addition, the evidence of inflationary pressures in some countries and the stability of unemployment despite de deceleration, would support the argument that potential output growth is below what was experienced at the beginning of this decade, and previous assessments were optimistic. The slowdown started before commodity prices started declining, and the terms of trade were not significantly low. Therefore it is difficult to blame external factors on the slowdown. However, the prospects of lower commodity prices will add to the drag of economic growth. The commodity price boom had a relevant effect on activity, but more than an income effect it resulted in an investment boom. This has been particularly relevant in the cases of Chile and Peru.

Figure 1: Per capita GDP
(Index 2008=100, constant national currency per person)



Source: World Economic Outlook database, series NGDPRPC. 2014 provisional and 2015-16 forecast.

Section 4 discusses the scope for expansionary policies in the region and what can we expect for the near future. Although monetary and fiscal policy may still have a role in supporting demand within inflation targeting regimes, the main problem in the region is not a lack of demand, but low productivity growth. Efforts must be made to foster productivity, and, more recently, the cost of institutional weakness and high degrees of inequality have shown areas were progress must be made to resume high sustainable growth. I close in section 5 with a few final remarks.

In general I focus on LAC7 countries. But Argentina and Venezuela have not only followed very different paths in terms of policies and performance in recent years, they also have less reliable statistics. For this reason I concentrate more on LAC5 countries, which excludes those two economies.

The global environment

The End of the Commodity Super-Cycle

Since the recovery from the crisis, emerging market economies, in particular China, have led growth in the world economy. While advanced economies were anaemic, recovering slowly, due to limited policy space and high leverage of households and governments, emerging markets were the engines of global growth. This development had positive spill-over effects on commodity prices since emerging and developing economies are more intensive in their demand for commodities. And Latin American countries are commodity exporters, so they have benefited from these developments.

Now the world engines are changing. In the developed world, the US is expected to grow faster and increase its contribution to global growth. Japan and Europe are still weak. Japan is trying to revive the economy with the three arrows of Abenomics, and the Eurozone has embarked, somewhat late, on a massive round of at least eighteen months of quantitative easing, while Grexit fears are back.

In contrast, growth in most of emerging and developing countries has decelerated, which has reduced the demand for commodities, and consequently their prices. In addition, the large and long boom of commodity prices had important supply-side effects, which has added

pressures to declining prices. Finally, the changes in composition of global growth have already been felt in the values of currencies around the world, with a global rise of the US dollar, with a consequent further weakening of commodity prices.

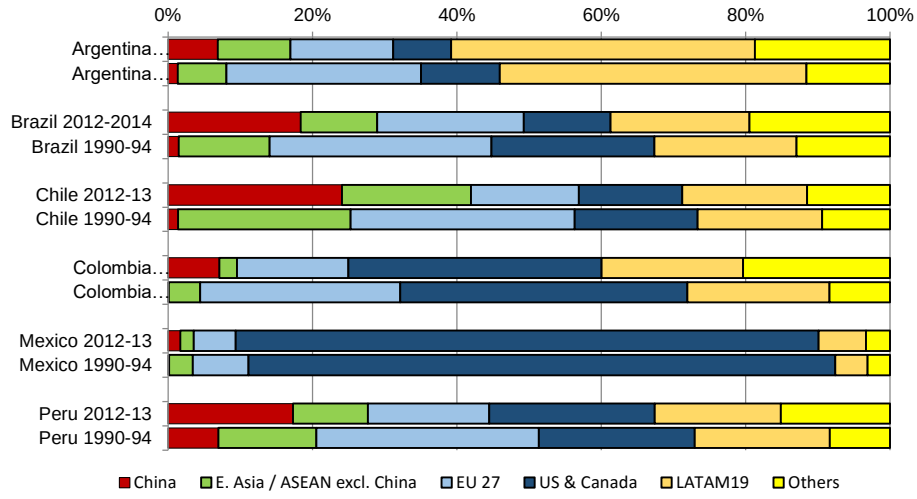
The reduction of economic growth in China has had direct economic impact in the region, as this country has become increasingly relevant for Latin America's trade (Kotschwart, 2014). On the other hand, despite the increasing role of China, this country only accounts for about 10 percent of the region's exports, but most of them are commodities. Figure 2 shows the exports of the largest countries in the region to China. Broadly, China has increased its importance in Latin American trade over the last twenty years, but still represents only a moderate fraction. This growth has been mostly at the expense of European Union imports. The most exposed country is Chile which exports about 24 percent to China, but once all Asia is considered this share goes to 42 percent. In addition, in the case of Chile only about half of exports to China are commodities, while in the other countries, non-commodity exports to China are quite small. In turn, Mexico basically trades with the US, and Argentina is the only one with significant intraregional trade, since its main export destiny is Brazil. In 2011, Brazil, Chile and Peru had a trade surplus with China, and therefore could be more affected by a deceleration in China. The high intensity of commodity demand from China directly affects the region via its effects on the price of exports rather than their volumes, since most of these goods can be sold elsewhere.

The decline in commodity prices has been uneven, in both timing and magnitude. Figure 3 presents the evolution of the most relevant commodity prices for Latin America in 2014, basing the index on the average value 2011-2013 to have this as a medium-term perspective on a period of high commodity prices. Most commodities started 2014 somewhat below the average of the previous years, so a small decline started already in 2013, with the exception of coffee that started 2014 with a very low price.

Compared to the average reached during 2011-2013, a period of relatively high commodity prices, the largest fall has taken place in oil and iron ore. The oil price has declined about 60 percent since mid-2014. The decline in copper and soybean, and most foodstuffs, has been about half of the fall in

oil price. Copper was more stable, but a sharper fall was observed late 2014 and early 2015. Coffee is the only commodity relevant for Latin America, whose price has increased sharply due to a supply disruption as consequence of a severe drought in Brazil.

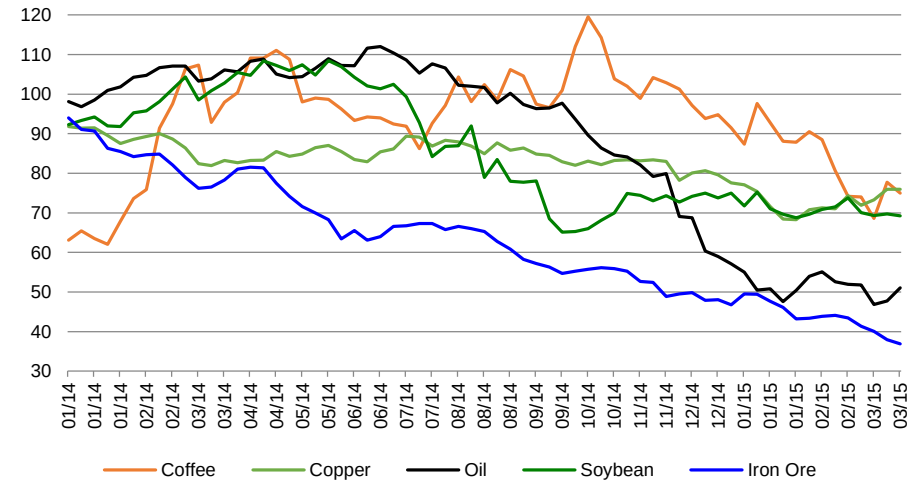
Figure 2: Export destination Latin America (percent)



A better view on the evolution of external prices for Latin America is to look at terms of trade, which combines not only prices of commodities exported and imported, but also trade in other goods. Unfortunately the available data are not entirely consistent, because of methodological differences. There are many sources, and even despite them often showing similar long-term trends, they present some discrepancies at higher frequencies. Given this caveat, Figure 4 shows the evolution of quarterly terms of trade from Haver Analytics for the period 2003-2014. The figure shows the commodity price boom in the high prices that prevailed after the global financial crisis, which were particularly high for Chile, Peru and

Colombia.[2] Despite difference in levels across different sources of data, what should be clear from Figure 3 is that there has been an observable decline in the terms of trade since 2011. But this decline is nowhere close in order of magnitude as an explanation for the deceleration that started mid-2013.

Figure 3: Commodity prices (average 2011-2013=100)



Source: Bloomberg.

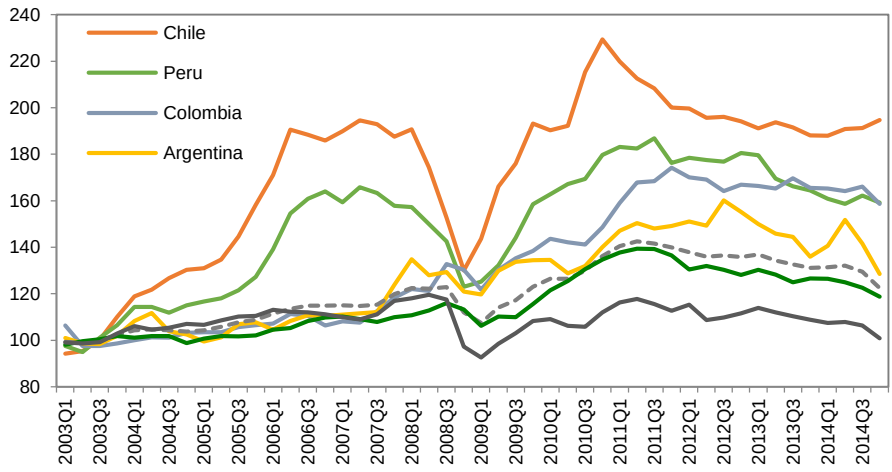
One factor that could additionally blur the domestic effects of terms of trade is that despite commodity prices remaining high with respect to the low levels of a decade ago, production costs are much higher, and hence the softening of prices has come together with a rise in production costs that further reduces profitability, which is related to the commodity investment cycle discussed in next section.

The most significant development in commodities market is the decline in oil price, which has differentiated effects according to whether countries are net exporters or importers of oil. On the fiscal front there are many

[2] There are no data for Venezuela, but other sources show that the increase in terms of trade was much larger in Venezuela tan in the rest of LAC7 countries.

channels through which oil affects the budget, and hence the implications are not direct. For example, in Mexico about a third of revenues come from oil, but the one-year ahead price is fully hedged. There are also price subsidies that should be phased out with the fall in oil prices, alleviating pressures on the budget. Overall, Venezuela is by far the most exposed to oil since it is a net exporter accounting for more that 30 percent of GDP in 2014, and more than 90 percent of their exports are oil. Ecuador and Colombia follow, but their exposition is less than a third that of Venezuela (Werner, 2015).

Figure 4: Terms of trade (index 2013=100)



Source: Haver Analytics.

In the weak scenario for oil prices, the IMF forecast that Venezuela's GDP will contract by about 7 percent in 2015, as severe domestic adjustments are needed. In Venezuela gasoline is virtually free, between 2 and 6 cents per litre depending on the exchange rate used to convert domestic prices. The government will have to increase the current price of gasoline, but any serious adjustments will not happen, as riots and violence cannot be ruled

out, especially given the dramatic current economic conditions. Probably, Petrocaribe, an initiative through which Venezuela has subsidized oil to Central American and Caribbean, will be adjusted, in particular its generous financing conditions, but most countries benefited by this initiative are large net importers of oil, hence the improvement in the terms of trade should mitigate, if not outweigh, adjustments of Petrocaribe.

In Brazil, Mexico and Peru, being small net importers, the drop in oil prices is beneficial, and in Chile the effects will be larger out of the LAC 7 countries. A decline in energy costs should improve productivity and have relevant effects on inflation, which in a context of deceleration of growth leaves an open space for increased monetary stimulus. The impact on inflation also varies from country to country, and it depends on the structure of taxes and subsidies to gasoline.

Overall, the decline in oil prices is good news for the region and for the world, although the sharp decline should cause some tensions in the adjustment, especially in economies that were managed as if the price would have remained high for long time. For the same reasons that the increase in oil price in the mid-2000s did not create a major global slowdown, since the world was more resilient to oil, the recent decline is good news, but not enough to create a boom.

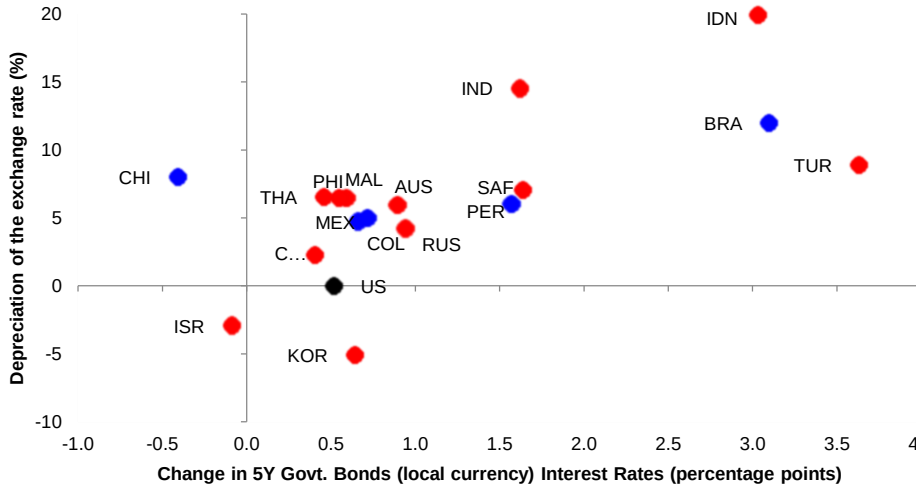
US Monetary Normalization, Trilemmas and Dilemmas

The other major development from the world economy is the likely monetary policy tightening, and quantitative easing in Japan and Europe. The change in domestic financial conditions as a result of changes in US monetary policy is a potential source of turbulence. The concerns are heightened by the financial links and spill-overs on emerging markets from the centre of the global economy, the US. Indeed, Rey (2013) has argued that there is not a policy trilemma as we have been used to think about monetary policy and exchange rates in an integrated world. This trilemma, known since Mundell-Fleming, states that it is not possible to have an independent monetary policy, to manage the exchange rate and to have free capital mobility. She argues the trilemma is reduced to a dilemma, since regardless of the exchange rate regime it would not be possible to have an independent

monetary policy in a world of free capital mobility. The global credit cycle would spread in the global economy and not be addressed by monetary policy alone.

The policy implications are strong. Monetary policy would be insufficient tool for stabilization purposes in small open economies with high degrees of financial integration. Some additional tools, such as macro-prudential policies, would be needed to recover monetary independence. If domestic conditions require loosening of monetary policy, the argument goes, but centre countries, basically the US, are tightening, domestic financial conditions would tighten too. This takes place even if the exchange rate floats.

Figure 5: Change in 5-year rates and depreciation after tapering announcement (6-months changes)



Source: Bloomberg.

Notes: The comparisons are the third week of November 2013 against second week of May. The announcement was made May 22nd.

How relevant is the dilemma is still unsettled. Obstfeld (2014) shows that indeed economies with flexible exchange rates are better prepared to mitigate changes in global monetary and financial conditions. There is still ability to have independent long rates from those at the centre. This is consistent with the view that economies that allowed their currencies to float performed better during the global financial crisis (e.g., Tsangarides, 2012; Alvarez and De Gregorio, 2014). Indeed, most emerging market economies were able to use significant expansions of monetary policy to mitigate the worst financial crisis, and tightening, since the Great Depression. This policy worked remarkably, especially when exchange rates were allowed to adjust.

Indeed, most of the discussion on the dilemma versus trilemma has focused on the impact of US monetary policy on credit and interest rates. However, the most important channel of transmission of monetary policy in small open economies is the exchange rate. Indeed, in a world of perfect capital mobility with instant adjustment of exchange rates, domestic interest rates would be equal to international rates, and adjustments would take place via changes in the value of the currencies.

An important case of rapid transmission of international financial conditions around the world was during *taper tantrum* in 2013. After the Fed announced in May 2013 that it would start to taper QE, financial markets enter a period of significant movements in asset prices. Long rates rose in the US and this was transmitted to most of the world, where long rates also increased. Most currencies depreciated against the US dollar, since demand for safety increased. Figure 5 shows the evolution of currencies and 5-year rates after taper tantrum for a number of Latin American and Asian economies, as well as some small open advanced economies. After six months of the shock, currencies were weaker and rates higher. The only exception to this pattern was Chile, were the depreciation was accompanied by a fall in rates, and Israel and Korea, whose currencies appreciated.

This is a demonstration of the repercussions of developments in the centre economy on the rest of the world. This financial shock did not translate entirely into tighter economic conditions, because exchange rates were allowed to float. The tightening effects of an increase in interest rates are partly offset by the expansionary effects of a depreciation. If currencies

would not have been allowed to weaken, the impact on interest rates would have been much larger.

We do not have evidence on what are the determinants of the different reactions of asset prices to global shocks. Certainly floating rates help to absorb shocks. However, the Chilean case provides some additional hints. Among all of these countries, Chile is the one with the lowest participation of foreign investors in the local debt market, and hence it is less affected by increases in risk aversion and flight to safety. Local investors, most of them institutional ones, tend to stay at home. This is a somewhat contrarian position to the long-held view of the so-called "original sin" (Eichengreen et al., 2005), by which a disadvantage of emerging markets was low holdings of domestic currency denominated debt by foreigners, limiting global risk sharing. This feature, that can be good in normal times, may exacerbate fluctuations to global shocks and limit the scope of monetary policy at times of turmoil. Having a large base of domestic investors should help to have monetary and financial conditions more independent from the rest of the world.

The slowdown

Last year took most forecasters by surprise. The revisions of forecasts through the year were significant. Figure 6 shows the change in the forecasts for Latin America between the IMF World Economic Outlook of April 2013 and that of January 2015. Two years ago the prospects for Latin America were that growth would go up between 2013 and 2014, the figures reveal, the reality was much worse. The two largest changes in Figure 6 are Peru, which was expected to grow at 6.1 percent, and will grow by about 2.5 percent, and Brazil, which was expected to grow at 4 percent, but will hardly grow at all. Argentina and Venezuela are excluded, but the deceleration has been even greater than those of the other countries shown in the Figure. The exception is Colombia which last year performed better than expected, and it is likely that the deceleration will have taken place this year.

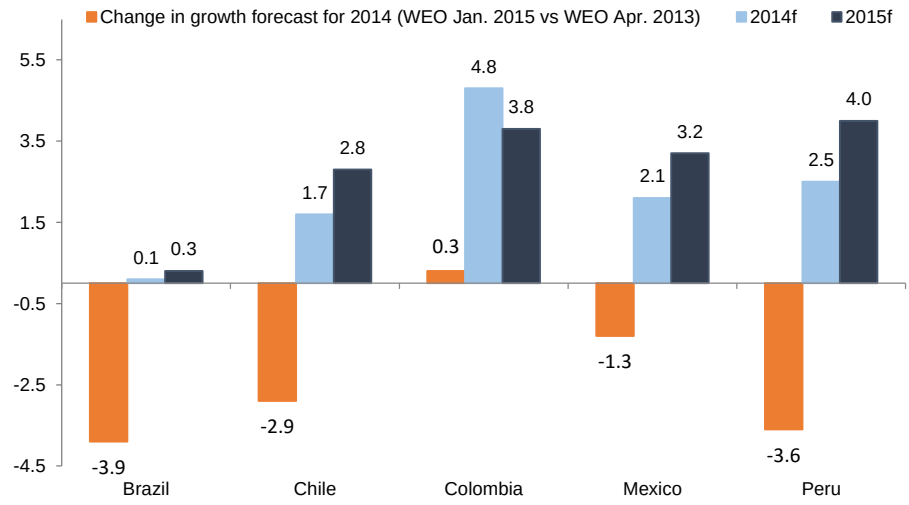
One would be tempted to blame some common external causes. The deceleration started in the second half of 2013 and the decline in the forecasts

started early 2014. In contrast, the decline in commodity prices came later and was not as strong as it has been in recent months. If global conditions were responsible for the deceleration, prospects for 2015 should probably be even worse. As I discussed before (Figure 4), the evidence on terms of trade does not show an extreme decline. In addition, global financial conditions have been sanguine. Latin American has been able to tap international capital markets at good conditions. Firms have issued large amounts of debt.

On what follows I will argue that the three main reasons for the deceleration are:

- Normal business cycles fluctuations with potential growth less than forecast.
- The commodity investment boom in Chile and Peru.
- Idiosyncratic domestic factors.

Figure 6: Growth forecast 2014-2015 and deceleration 2014 (percent)



Source: IMF, *World Economic Outlook*, April 2013 and Update January 2015.

The Business Cycle and Long-Term Growth

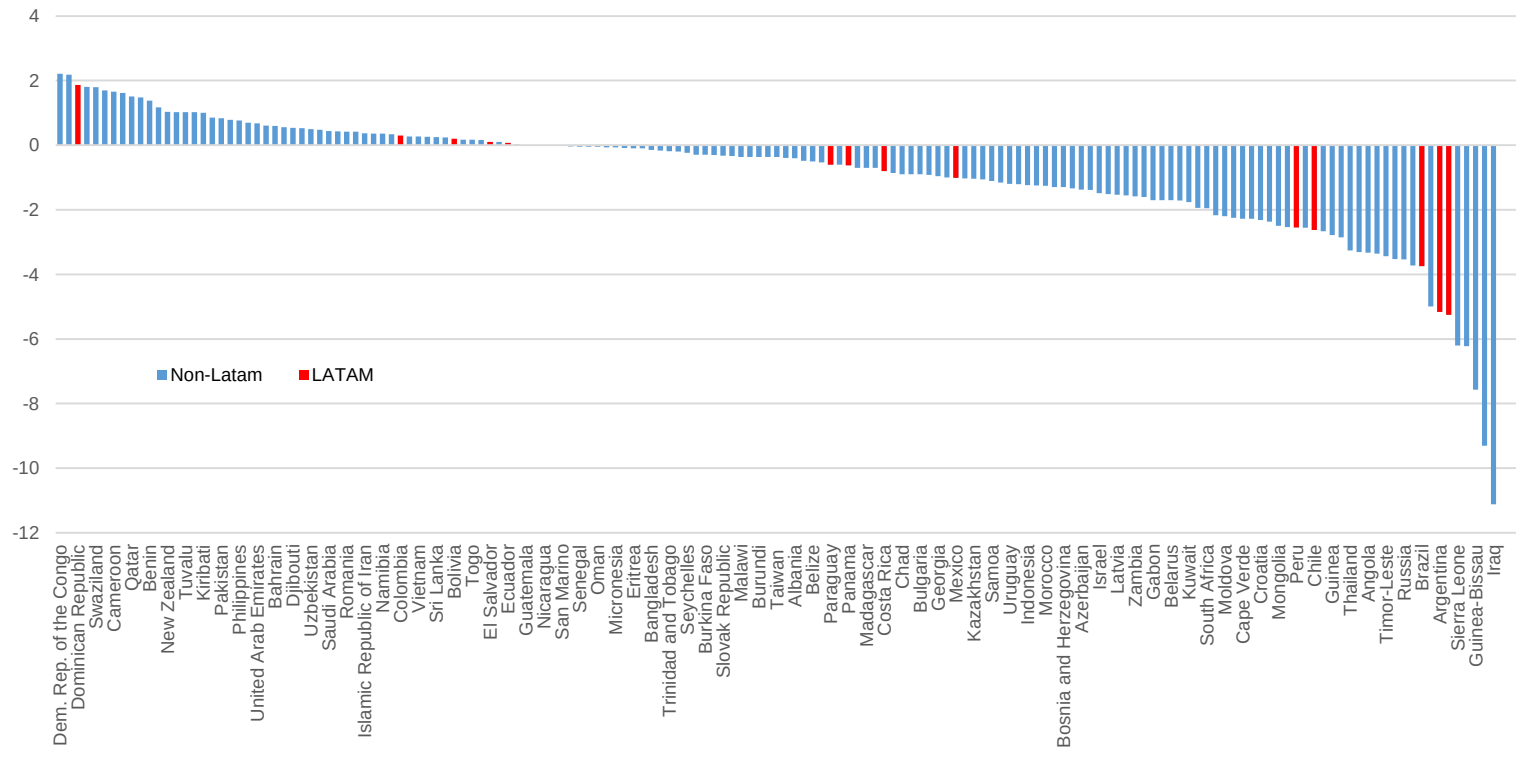
It is interesting to note that not only in Latin America, but also all across emerging markets forecasts were optimistic. The difference between the forecasts made by the IMF in April 2013 and October 2014 is presented for all non-advanced economies in Figure 7. [3] However, among the top five countries with the largest adjustments are Argentina and Venezuela, where macroeconomic distortions are significant, and where economic performance has deteriorated sharply. These countries are also, especially Venezuela, very dependent on the commodity price cycle.

But clearly there were negative surprises. This happened not only with official forecasts, but also with the predictions of Consensus Economics and other private forecasters. This, of course, has many implications, such as creating depressing effects on asset prices and business confidence. The year 2014 was certainly a year of disappointment in emerging markets.

We know that forecasts are inaccurate when used to try and predict turning points (Ahir and Loungani, 2014), but also they do not make a very good job at forecasting long-term trends (Ho and Mauro, 2014). Latin America, in particular, has not been used to a regular business cycle. In the past, recessions were very deep, recoveries slow and the dependence of domestic economies on international conditions was significant. In the recent crisis, using aggressively conventional macroeconomic policies for the first time in many years, the contraction was limited, given the size of the shocks, and the recovery was quite rapid. But economies cannot grow persistently above trend, and at some point they slowdown. The role of policy is to avoid excessive cyclicality, but it cannot be eliminated altogether.

[3] All countries with less than 2 million people of less than US$2,000 of per-capita income at market prices were excluded. The pattern does not change when all countries in IMF (2014) are included.

Figure 7: Change in growth forecast for 2014 emerging and developing economies (percent)



Source: IMF, World Economic Outlook, April 2013, October2014.

Forecast errors occur not only because the cycle is difficult to predict, but also because of excessive optimism about long-term trends, in particular the rate of growth of the full capacity of the economy. Times of success and high growth tend to create the impression that high growth will persist, but rapid take-off growth spurts do not last forever and growth rates will normalise. Periods of unusual growth do not persist in the long run.[4] An early regional example was Chile which experienced a rapid take-off between the late 1980s all through to the Asian crisis, to then normalize its expansion. More recently, Peru has had an impressive economic performance in recent years. Between 2005 and 2013, the Peruvian economy grew at an average 6.6 percent per year - certainly not its long run rate of growth.

In Brazil, persistent long-term growth performance has been missed by the largest margin. Between the successful stabilization of the early 2000s and 2008, the average annual growth was 4.8 percent. Then, after a small recession in 2009, with a decline in output of 0.3 percent, Brazil recovered strongly growing at 7.5 percent in 2010. Nevertheless, since 2011 average annual growth has been 1.6 percent, and is expected to be very low in the next few years. As late as the end of 2013 potential growth was still expected to be 3.5 percent (Kaufman and Garcia-Escribano, 2013), which with hindsight was quite high. Brazil did a very successful stabilization in the late 1990s and early 2000s, which of course it is not assured for the future. But Brazil is also very much a distorted economy, from credit allocation to the tax system and weak institutions; there are certainly serious impediments to sustain solid economic growth.

Therefore, the inability to predict neither the turning points as well as the medium term path for output caused optimistic forecasts. However, with the exception of Colombia, the largest Latin American countries rank quite high in the forecast revision. This suggests that there is more to explain than a simple inability to catch up the full nature of the business cycle.

Colombia, although it was an exception in 2014 this does not mean that it has some special resilience to business cycle fluctuations, but perhaps it is more a matter of timing. One key factor that allowed Colombia to keep

[4] For a recent review of the evidence, in the context of China's growth prospects see Pritchett and Summers (2014).

strong growth during last year was an aggressive infrastructure program, which offset a decline in private investment. But this cannot be a source of permanent growth, which together with the effects of the fall in oil price is reducing growth prospects. While a year ago growth was expected to be about 4.5 percent in 2015, current estimates are closer to 3 percent.

The Copper Investment Boom in Chile and Peru

We are used to thinking that commodity price booms increase income, demand, and generate an output boom. Government revenues and households incomes rise, which stimulates demand. This is the traditional transmission mechanism through which investment induces a multiplier effect on economic activity. On the other hand, an appropriate macroeconomic framework can reduce the income-induced commodity price boom. Fiscal policy that saves in good times to spend in bad times, a flexible exchange rate that acts as a shock absorber, and a credible monetary policy can limit the effects of commodity prices fluctuations.[5]

The mitigation of the income cycle is particularly relevant in the case of copper. A significant part of the profits generated are not national, but belong to foreign investors. The government owns another relevant share, and hence, the cycle can be mitigated with an adequate management of windfalls. Traditional income effects are more likely to take place in agricultural commodities, where benefits are widespread and domestic demand booms are likely to take place when commodity prices increase. Moreover, as discussed in the previous section, the decline in terms of trade has not been of a magnitude that could explain a large fraction of the slowdown through income effects.

Nevertheless, a commodity price boom can still induce an economic cycle, not through income effects, but through its effects on investment. When investors perceive a long lasting rise in commodity prices occurring, they have the incentive to initiate investment. Copper extraction is a very capital-intensive activity and investment in the initial phases is quite significant and has spill-over effects to many other sectors. This results, for example, in

[5] Indeed this seems to be the case of copper in Chile, as discussed in De Gregorio and Labbe (2011).

important demand on the construction sector. The investment process generates a relevant increase in aggregate demand, and this induces a boom. In this case investment is having an accelerator effect on economic activity. When all projects have been developed, there is a decline in investment, regardless the price, which can be aggravated in context of declining prices. Thus, while the traditional view on commodity price booms emphasizes a *multiplier income effect, the evidence would support an investment accelerator effect.*

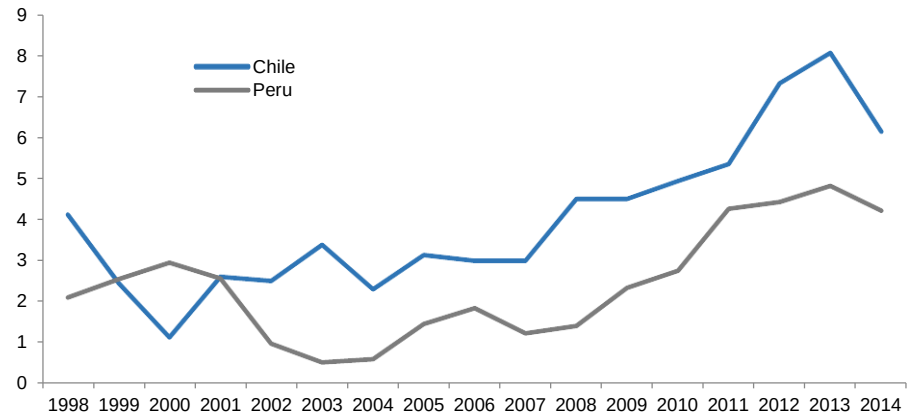
This issue has been recently investigated in Fornero *et al* (2014).[6] Their empirical results, using econometric estimations and simulation within a general equilibrium model, show that indeed the rise in commodity prices has an important effect on investment in mining, with relevant spillovers to the rest of the economy. In their detailed look at the Chilean case, they claim that most of the above average investment undertaken during the boom was induced by rising commodity prices. During the crisis, the investment boom mitigated its effects.

The evolution of mining investment in Chile and Peru is presented in Figure 8. From the mid-2000s to 2013 investment in mining increased between 3 and 4 percent of GDP, a quite sizable amount. It declined by about 2 percent of GDP during 2014 in Chile, which of course induced a relevant deceleration of aggregate demand. This is coherent with a 2 percent of GDP decline of fixed investment as estimated by the Central Bank of Chile (2014). In the case of Peru, the decline in 2014 has not been as deep as in Chile, and therefore it accounts for less of the significant slowdown in activity. Indeed, in a recent publication, the Central Bank of Peru (2015) expects a fall in fixed investment of 1 percent of GDP in 2014. As discussed below, in Peru there are some additional idiosyncratic factors that helps to explain the deceleration, but there could be further drags on economic activity as investment in mining keeps adjusting downwards.

[6] I am grateful to the authors for sharing their data on investment in mining.

These results are consistent with the work of Gruss (2014a), who finds that "even if [commodity] prices were to remain stable at the relatively high levels observed in 2013, the annual output growth rate over the medium term (2014-19) would be almost 1 percentage point lower than in 2012-13." Although the mechanism is not explicit, this is consistent with the investment cycle. The effects are greater for Peru, average for Argentina, Chile, Colombia and Venezuela, and less than average for Brazil.

Figure 8: Investment in mining: Chile and Peru (percent of GDP)



Source: Chile, Central Bank of Chile and Cochilco.
Peru, Ministerio de Energía y Minas and Sociedad Nacional de Minería, Petróleo

Another relevant economic effect that investment cycles associated with commodity prices have is on the current account balance. When commodity prices are high, the investment boom can induce a deterioration in the current account balance, despite high export prices, due to the investment boom. This would be an offsetting effect to the increased value of exports. In contrast, the decline in commodity prices may be offset by a fall in investment and a consequent narrowing of the current account deficit.

Country Specific Issues

It is likely that LAC5 will not be able to grow at the rates experienced during the commodity price boom. Some will see declines, where falls in investment and fiscal tightness, are expected. In the case of Mexico, where first quarter figures of 2014 were severely affected by a US poor performance, important legislation to open oil investment to the private sector in joint ventures with Petróleos Mexicanos (PEMEX) was introduced. An energy reform was also enacted to allow private sector participation, in a sector that needs investment. The reforms produced an increase in confidence, but the recent decline in the oil price is not good news for this area, and perhaps the growth gains estimated from this reform, about half a percentage point, will decline as incentives to invest have fallen with the lower oil price.

Peru has faced some problems in mining and fishing. Indeed, due to climate changes, fishing, an important sector for Peru, fell by about 25 percent in 2014, while a year ago it was expected to grow at 7 percent. This also affected manufactures associated with the fishing sector. Similar supply problems, although to a lower magnitude, have been faced in mining. This year seems to be more promising, but it is unlikely that Peru will return to growth of 6 percent a year.

Chile is one of the most interesting cases. Being the star performer in terms of pro-growth environment, more recently the country has been involved in a number of reforms that have introduced uncertainty and have deteriorated the business climate. The source of the reforms was the mandate given to the incoming administration to take action to foster social inclusion. This case is important, because other countries in the region may go down a similar route, as discontent about inequality has been mounting. Social reforms during the 90s and the previous decade were, rightly so, oriented toward coverage of social services. For example, there was a significant increase in tertiary education enrolment, with supply being provided by the private sector. In this case, fees were high and quality low, which triggered massive demonstrations in 2011. In some respect, one can argue that Chilean social policies "were behind of the curve," at least behind public expectations. Many demands are justified (in health and education for

example), but they were not addressed in time, so the pendulum swung the other way. No government would have been able to sidestep these demands.

As a first step, a tax reform was introduced to fund social needs. The reform will be implemented gradually up until 2018. The purpose of the tax reform is to raise fiscal revenues by 3 percent of GDP. This would lead, in a period of three years, for central government expenditure to go from about 22 to 25 percent of GDP. This reform has been followed by educational reform, electoral reform and more recently proposals for labour market reform. The reforms have had broad support, but actual legislation has been somewhat confusing, contrived and in some cases inappropriate. This has created uncertainty and probably adjustments will have to be made in the future. This has undermined confidence in the investment environment. The uncertainties will be resolved over time as if becomes more clear the full extent and actual implementation of the reforms. However, the fundamentals of Chile's success, such as free markets, an open economy, an independent central bank, strong fiscal policy, and a sound financial system, still remain in place. And now, reforms to increase social inclusion, assuming they are effective, should allow growth with social cohesion.

Finally, is the case of Brazil, which has also suffered negative shocks. The country was affected by one of the most devastating drought in decades which has been very costly in a country were 70 percent of power generation is hydroelectric. The first effect has been an increase in energy prices, but electricity rationing and water shortages are likely. This drought has been also responsible for the increase in the price of coffee, as a large fraction of the crop was destroyed.

Brazil is also affected by the decline in oil price. It has one of the largest deep-water reservoirs, but they may become unprofitable at current oil prices. On top of this, the massive corruption scandal in Petrobras, a public partner in these projects, have undermined even further investment prospects. Moreover, the corruption case of Petrobras is having serious spill-overs on economic performance and political climate.

But also Brazil has one of the lowest levels of growth potential among LAC5 countries, and this is revealed by the conduct of monetary policy that will be discussed in more detail the next section. Despite low growth, the

central bank, following an inflation target has been tightening monetary policy. This is an indication that Brazil is close to full capacity. Brazil needs to carry out reforms to increase productivity. Removing severe distortions in the allocation of credit, opening up the economy, rationalizing a distortionary and high tax burden, and seriously addressing corruption should be high on the agenda. Demand policies are not the solution.

Slowdowns without Unemployment

At many times there have been concerns about jobless recoveries, as happened in many emerging markets after the Asian crisis. Although, this time the reverse has not happened. In the LAC5 countries the slowdown has come without a significant increase in the unemployment rate. Figure 9 shows the evolution of unemployment, where despite lower growth unemployment has been relatively stable, or even falling. In Colombia, the exception to the slowdown, unemployment has declined between the end of 2013 and 2014. In contrast, in Brazil, Chile, Mexico and Peru, unemployment has been quite stable, or has even declined some decimal points. Only at the beginning of this year, the unemployment rate has been rising in Brazil. But, this increase cannot be blamed on lags since Brazil growth has been low since 2011.[7]

This evidence seems to be at odds with a standard application of Okun's law, which tell us that when countries are growing below potential, unemployment goes up. For advanced economies the effect is about 30 to 40 basis points increase in unemployment by 100 basis points lower growth with respect to potential (Ball et al., 2013). Recent data for the region are difficult to reconcile with the standard Okun's law.[8]

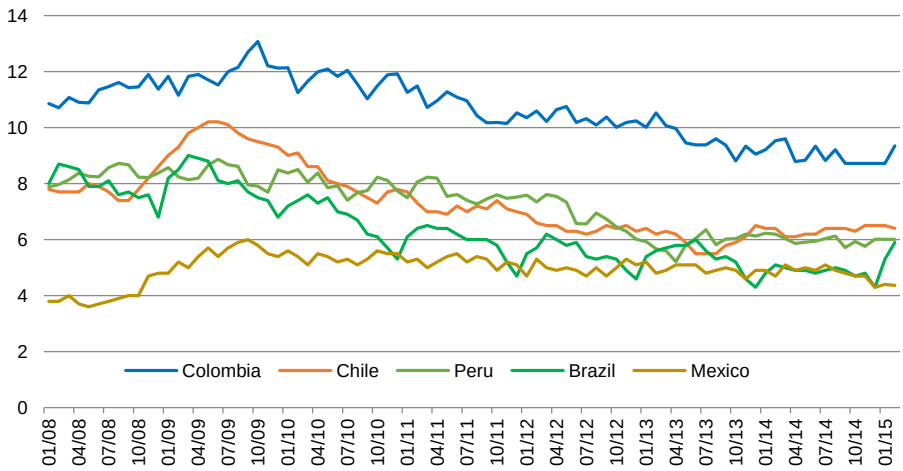
These sanguine unemployment figures have provided some relief to domestic authorities on public perceptions about the slowdown. This was important, for example, in the reflection of Dilma Rouseff in Brazil, where

[7] According to official figures, in Chile unemployment increased from 5.7 to 6 percent between December 2013 and 2014 while the decline in growth is about 2.4 percentage points. In the text, figures for Chile and Mexico are taken from the OECD harmonized statistics. There are many alternative series of unemployment across countries, but the evidence in the text is robust compared with using other measures.

[8] Gruss (2014b) presents Okun's law estimates for Latin American countries and the coefficients are smaller than those found in advanced economies.

despite lower growth, performance in terms of the unemployment rate has been upbeat. Employment growth has decelerated significantly in recent quarters, but this has been compensated by changes in the labour force that have resulted in a relative stability of unemployment rates.

Figure 9: Unemployment rates (percent)



Source: Brazil, Colombia and Peru, Bloomberg. Chile and Colombia, OECD, harmonized unemployment rates. Data for Colombia and Peru were adjusted by seasonality. For Chile and Mexico, OECD harmonized data. Latest available for Chile is December and for Mexico is January. Data until February were extrapolated using official statistics.

There are a number of potential explanations for this *"unemployment-less"* slowdown. Productivity has not been growing, and hence slow growth may still allow some increase in employment. Whether this is a transitory or permanent is not obvious. From an Okun's law point of view, this stability in unemployment could be interpreted as a decline in potential growth. It is also possible that the composition of unemployment has changed. This has been observed in Chile where the proportion of self-employed has increased. In this case employment would adjust on the intensive margin (hours) rather

than the extensive one (numbers employed). Perhaps people that lose a job are also quitting the labour force. Or finally, lags in unemployment adjustment could have lengthened. This issue certainly deserves more research. There is a positive reading of the evidence since unemployment rates do not go up, and that is good, but on the negative side they are the counterpart to low productivity growth and probably a low rate of long-term growth. All the evidence would point to the fact that low productivity growth has dented long-term potential growth.

The road ahead

Prospects for Latin America growth are moderate (Figure 6). Moreover, most current private estimates predict less growth than those of Figure 6. Chile, Colombia, Mexico and Peru are likely to grow about 3 percent, while Brazil is likely to have negative growth of between 0 and -1 percent. Argentina and Venezuela may have even larger declines in GDP. This will have been another year of mediocre growth.

In a world with weak commodity prices, with economies coming out of strong recoveries, and above all with potential output growth below what was experienced in the aftermath of the global financial crisis, Latin American economies will grow at more moderate rates in the near future. Three to four percent growth could be perhaps the new normal. There are two main challenges in this context. First, macroeconomic policies need to be consistent with this new scenario and support stability and, second, policies are needed to spur productivity growth. I will start by reviewing macroeconomic policies and then will focus only on the issue of inequality.

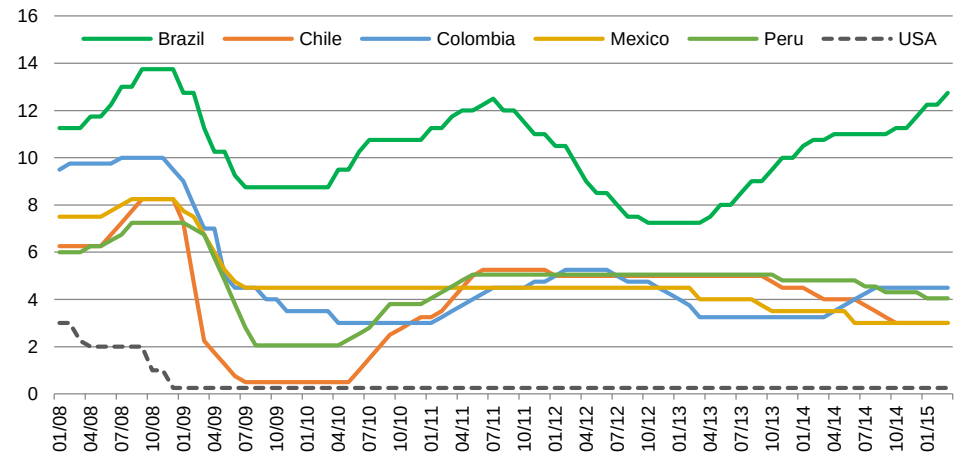
Macroeconomic Policies and Exchange Rates

The global financial crisis witnessed a significant loosening of monetary policy, which was a key factor in speeding up the recovery (Figure 10). After the recovery took place, monetary policies in Latin America started a process of normalization, with the only exception being Mexico which was the country which had the smallest loosening and which has not raised interest rates since the global financial crisis started.

The normalization process continued until 2011-12, and then, with the decline in actual and projected inflation (Figure 11), there was a more systematic loosening in Chile, Colombia, Mexico and Peru. The case of Brazil is a special one and I will comment on it in greater detail below. The loosening of monetary has continued until recent months, with the exception of Colombia that has been growing steadily and, consequently, monetary policy has been gradually tightening. This trend may revert as the Colombian economy has started to weaken.

Last year inflation developments were challenging in most countries, most notably in Chile, where inflation primarily increased significantly as a result of the pass-through from a significant depreciation of the exchange rate to domestic prices. Although, in principle, this process should not generate significant persistent effects on inflation, especially when the economy is decelerating, the room for further monetary loosening is limited. The recent sharp fall in oil prices and low growth should alleviate inflationary pressures, but this has not been enough to warrant monetary loosening.

Figure 10: Monetary policy rates (percent)



Source: Bloomberg.

A key factor to allow for a more expansionary monetary policy is an increase in excess capacity. Excess capacity, does not only depend on the current rate of growth, but also on the expansion of potential output (full capacity output). As discussed before, it is not clear that excess capacity is increasing, since probably potential growth has fallen. This makes it more unlikely that significant monetary loosening will occur which will depend on how authorities evaluate their current position on the business cycle across countries.

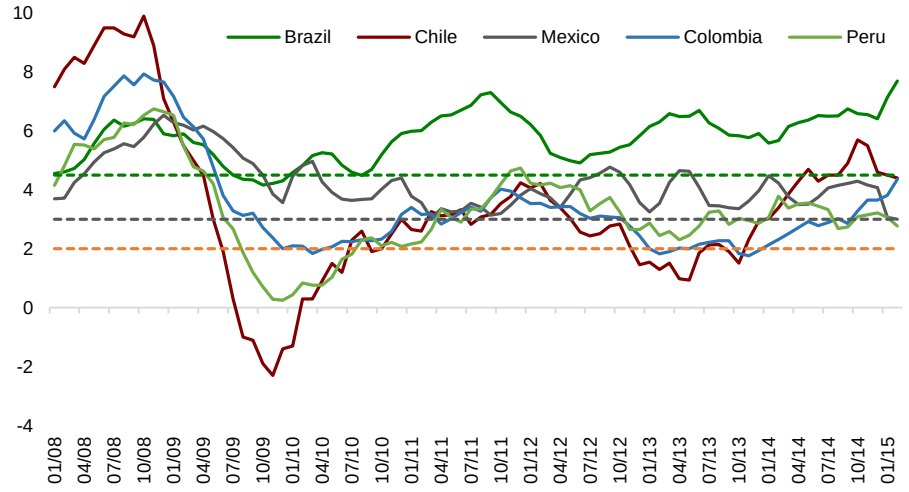
Brazil's monetary policy is special. First of all, the monetary authorities follow an inflation target, and most of the time the mid-point has been missed from above. In a credible inflation target regime when inflation is rising, this is likely to be the result of the economy operating above full capacity, and the monetary policy response is to tighten. This is the first indication that Brazil, despite low growth, has hit the full capacity limit and to grow faster it needs to foster productivity. Demand policies will not help in a lasting way.

But Brazil has another particular, perhaps unique, feature of monetary policy. With the Selic rate (monetary policy rate) at 12.75 percent and inflation running at 7.7 percent, it is perhaps the country with the highest monetary policy real (*ex-post*) interest rate, of about 5 percent. Moreover, government bond yields are also about 12 percent too at all horizons. Real rates today in the world are substantially lower and it is difficult to think that at this rate an economy can grow, but despite the current slowdown, Brazil has been able to grow with very high Selic rate, since this has been going on for many years. However, while the Selic real rate is very high, development banks lend at much lower rates. The lending from BNDES (the Brazilian main development bank) is set on the basis of the long-term interest rate set by the National Monetary Council, which is outside the central bank. Since 2003 this rate was permanently declining to reach 5 percent, and just recently was increase for the first time to 5.5 percent.

In this context, monetary policy in Brazil is impaired. The Selic rate, and monetary policy in general, has had limited effects on the financial conditions prevailing in the economy. It can only affect credit outside the scope of development banks, which might amount up to a half of current lending.

Many borrowing by SMEs, as well as a most consumer credit, is outside the scope of development banks creating a tiered system.

Figure 11: Inflation rates (percent)



Source: Bloomberg.
Note: Dashed lines correspond to current inflation target (Brazil 4.5%, Chile 3%, Colombia 3%, Mexico 3% and Peru 2%).

Government funding costs are linked to the Selic rate, while lending through public banks is done at much lower rates. This represents a government subsidy and should go into the public finance statistics. The gap between the Selic rate and lending rates at development banks explains the puzzle of why Brazil has been able to grow despite having one of the highest monetary policy real rates in the world.

The other transmission mechanism of monetary policy is the exchange rate, and in the case of Brazil, given the impairment affecting credit conditions, it is a key channel. This is why the authorities are concerned about sharp fluctuations in the exchange rate, more than in countries like Chile, Colombia or Mexico. They were the ones that raised the issue about

currency wars, accumulated reserves and introduced capital controls at the times of appreciation. With bond yields at more than 10 percent and an economy doing well as in 2010, incentives for carry trade were significant and this is the reason for the Real's appreciation of some years ago. It was not a currency war.

When emerging markets currencies started depreciating, the Brazilian authorities removed capital controls and intervened in the foreign exchange market to tame the depreciation. As the pass-through from exchange rate to prices has declined in most emerging markets along with currency floats and inflation, (Mihajek and Klau, 2008), this channel requires stronger responses from the perspective of both monetary policy and the exchange rate. Indeed it is interesting to note that the tightening of monetary policy in Brazil during the latest cycle started in March 2013, before taper tantrum, when the Brazilian Real started depreciating at a steady and relevant pace (Figure 12).

Recent announcements to reduce transfers to development banks for three years should help to rationalize the operation of the financial system, Brazil could afford to reduce significantly the Selic, but with a significant increase in the lending rate of development banks. The transition and political implementation are quite complex.

With commodity prices weakening, domestic activity slowing down, and external financial conditions tightening, exchange rates must depreciate. This is the expected response of the value of the currencies when they are allowed to adjust and act as a shock absorber. This is what has happened in LAC5 countries (Figure 12). After being relatively strong during the period 2010-12, the depreciation of the currencies started in 2013. Compared to early 2013, the Brazilian Real and the Colombian peso have depreciated about 50 percent. The Chilean peso, which started depreciating earlier, has had an accumulated fall of about 30 percent. The Peruvian Nuevo Sol has depreciated more gradually and less, despite suffering a shock similar to that of Chile. The high degree of dollarization in Peru results in somewhat greater fear of floating, since authorities allow for adjustments to take place gradually. But, further depreciation is needed to resume growth. The case of Mexico is different since its currency moves closer to the US dollar given their high degree of economic integration.

Figure 12 shows that the weakening of LAC5 currencies with respect to the US dollar has coincided with a global strengthening of the latter, measured on the basis of a wide currency basket. Therefore, the magnitudes of the gains in competiveness have been less than those reflected in the figure, since the real depreciations, measured by some real effective exchange rate measure, have been smaller.

The exchange rate should facilitate external adjustment, and hence, we should expect the current account balance to improve. Progress in this area has been limited. Figure 13 shows the evolution of IMF's forecast of the current account deficit for 2014 (deficits are recorded as positive numbers). The third bar represents the change in the forecast between April 2013 and October 2014, in the same way as it was done before with the growth forecast. Therefore, this implicitly measures the impact of the deceleration plus the depreciation on the current account.[9] Chile is the only case where the most recent forecasts show a decline in the current account deficit. The forecast fell from levels close to 4 percent of GDP to somewhat in the order of 2 percent. In this case, however, it has been mostly expenditure reducing rather than expenditure switching. Most of the adjustment comes from a fall in imports, with a large component being imports of capital goods related to the decline in investment, rather than an increase in exports.

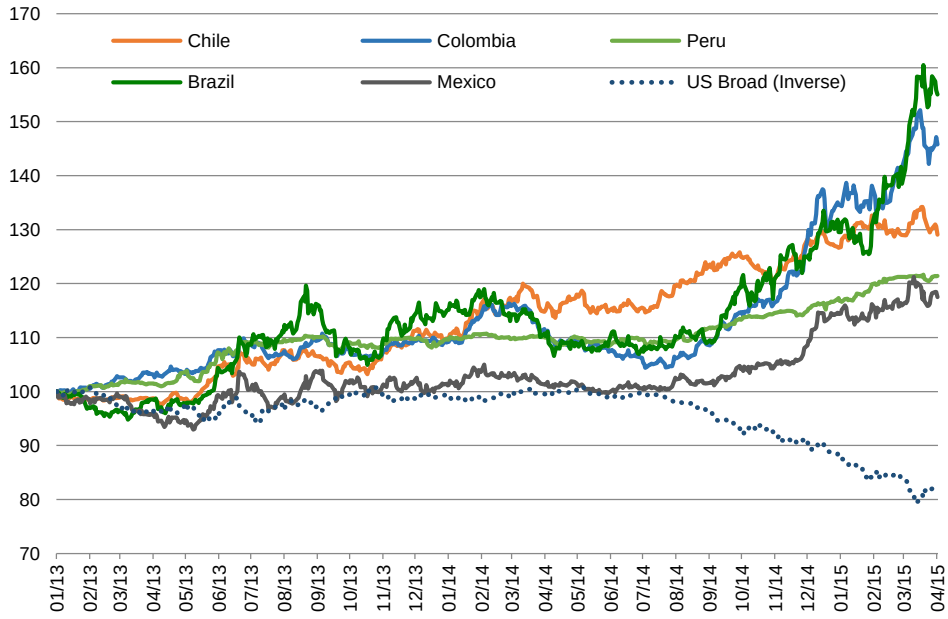
The lack of current account adjustments could be due to lags with which the exchange rate depreciation affects net exports, changes in terms of trade or because of lack of adjustment of aggregate demand. Forecasts for 2015 show that there is still no reversal, and this year's balance of payments position is expected to be similar to the one of last year.

This leads to an important issue regarding exchange rates and external adjustment. The impact of exchange rate fluctuations on inflation have decreased substantially over time, as low inflation has consolidated and currencies have been allowed to float. If prices react less to exchange rates, relative prices will be more stable and there will be less expenditure switching. Relative prices are still relevant for external adjustment changes,

[9] IMF estimates of the current account deficit show some inertia in the face of large exchange rate changes. For further discussions on this point see Cline (2013).

as export competiveness increases in a world of local currency pricing (De Gregorio, 2014, chapter 3).

Figure 12: Exchange rates (January 2nd, 2013=100)



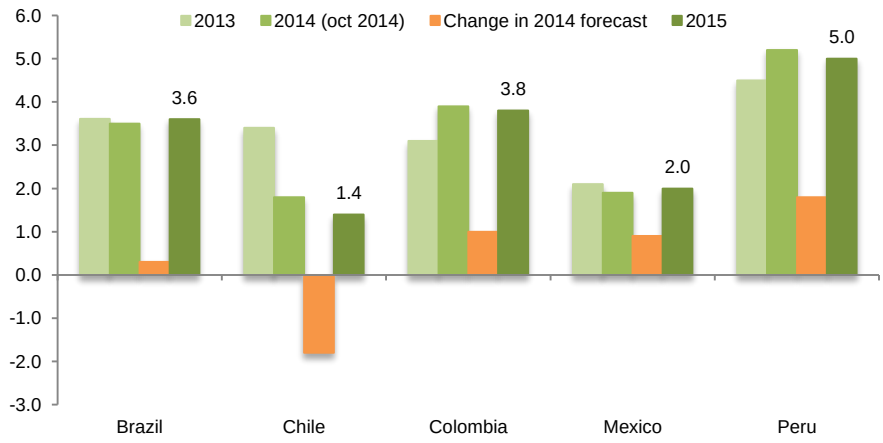
Source: Bloomberg.
Notes: Exchange rates are measured as domestic currency per US dollar, an increase represents depreciation. The dollar is a broad index (Bloomberg inverse of DXI index) measure as unit of US dollars per foreign basket of currencies, decline is an appreciation.

On the fiscal side, I emphasized in De Gregorio (2014) that '*fiscal stickiness*' exists. The strong discretionary expansion of government expenditure during the crisis was not completely undone when the economies recovered. This happened not only in Latin America, but also in most emerging market economies. This reduces the space for future countercyclical fiscal expansions, especially in countries where issues of sustainability are more relevant. More automatic stabilizers would be

needed, in particular on the expenditure side, to add counter cyclicality to fiscal policy. Moreover, although transfers and fiscal expansions may be quite important to alleviate the cost of a deceleration, their expansionary capabilities are not warranted (Alvarez and De Gregorio, 2014).

Fiscal solvency varies across the region, which limits the space for some countries to support activity via fiscal policy. Figure 14 shows net and gross public debt by countries. Chile and Peru have basically no public debt, while fiscal space is somewhat more limited in Brazil, Colombia and Mexico. Brazil faces greater challenges than other countries as in 2014 it missed its fiscal goal by a large and increasing margin. The fiscal goal was a primary surplus of 1.9 percent of GDP, but it ended up with a deficit of 0.6 percent, resulting in increasing public debt as share of GDP, since the economy also did not grow. The goal became ambitious, as the government wanted to reach a 1.2 percent primary surplus in 2015 and then to move in the following years to a surplus of 2 percent.

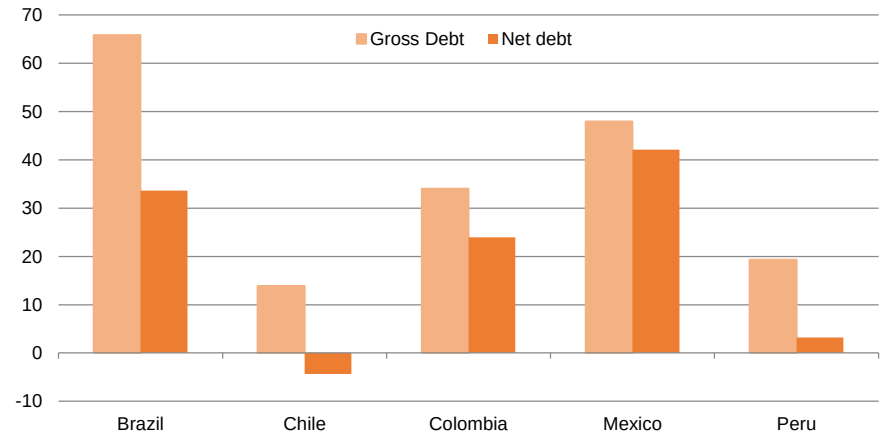
Figure 13: Current account deficit and forecast adjustment (percent of GDP)



Note: A positive number is a deficit. The difference is the change in the forecast between April 2013 and October 2014. A positive figure is a widening of the deficit.
Source: IMF, World Economic Outlook, April 2013 and October 2014.

But if there is no need to create a surplus for fiscal sustainability reasons, these are not times for fiscal contraction. Fiscal policy, wherever possible, must be supportive. Authorities should announce medium term plans of fiscal austerity, but there is no need to engage in frontloading. This is a challenge for countries whose public finances will be affected by the fall in commodity prices, in particular when no strong rules to save the windfalls of the boom are in place. With hindsight, it would have paid to have anticipated that the commodity boom would not last forever.

Figure 14: Public debt (percentage of GDP)



Source: IMF Fiscal Monitor, October 2014.

The Perils of Inequality

There are many challenges in order to stimulate economic growth in the region. This is not the place to discuss them, but institutional weaknesses are high on the list.

Corruption and crime do not only damage growth potential, but also have direct impact on the quality of life in the region, especially crime. Latin

American countries rank high in crime indicators, with Honduras, Guatemala, Venezuela and El Salvador ranking at the top. The appalling crimes in Iguala, Mexico, the corruption scandal in Petrobras that may extend to several other companies and sectors in the Brazilian economy, the murder of an attorney in Argentina, and the political crises in Chile and Peru are examples that show there is a need for important institutional progress. Transparency, accountability and responsibility are key to good governance. There is a need to deepen democracy and improve the workings of the market economy. The challenges ahead are different across countries as there are differences in their starting point. Although sometimes the costs of poor institutions are not felt in the short run, because business can accommodate to distortions, but they certainly undermine the potential to foster long-term economic growth.

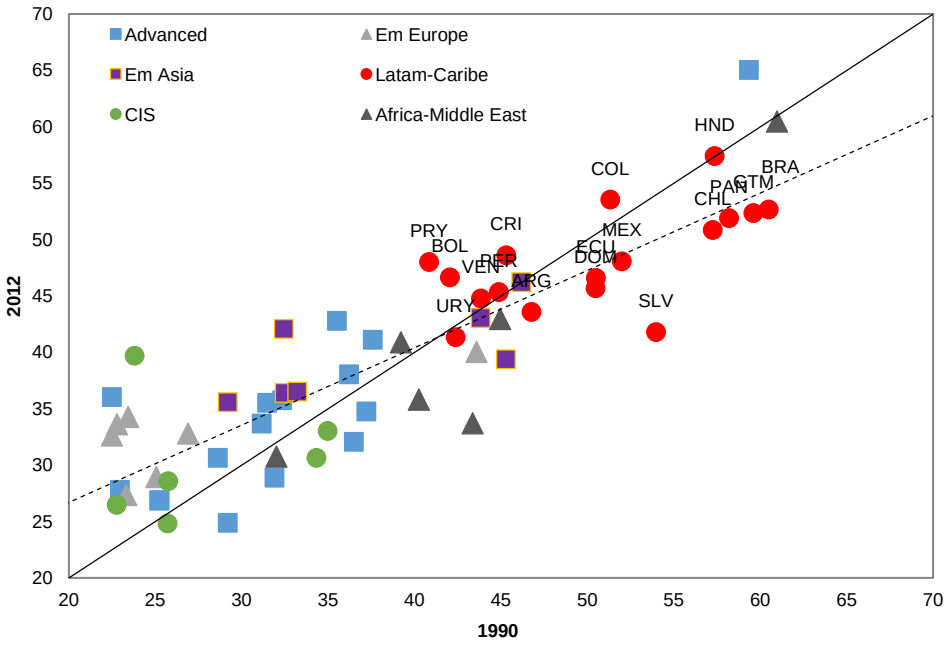
There are many reasons to explain the weakness of institutions, corruption, populism and macroeconomic imbalances in the region. Some of them can be traced to the high levels of inequality in Latin America. It should be noted that the direction of causality also runs in reverse, namely, that poor institutions weaken the scope to reduce inequality. High levels of inequality may become a difficult hurdle to cross in order to maintain solid economic growth.

The evolution of inequality for a broad sample of countries is presented in Figure 15, and allows placing Latin America in a time and a global perspective. It plots—using data from the World Bank and restricting the sample to countries with more than 2 million people and 2 thousand dollars per capita—the Gini coefficient for 1990 and for 2012. Inequality increased (decreased) in countries above (below) the diagonal. The regression line is the dotted one. This line shows that at initial high levels of inequality this measure has declined, while it had increased in countries initially more equal.

This implies that between countries inequality has declined in the world. Latin America is one the most unequal regions in the world. Inequality has declined in the last twenty years, but still remains relatively high. There are some few countries where inequality increased, but going beyond country specifics, the overall view has been a reduction of inequality in the region.

Certainly there are things that have been done well, in addition to economic growth, and help to understand recent developments (López-Calva and Lustig, 2012). But there is discontent. In the first faces of growth and stabilization, the process enjoys big support, and inequality is not a serious concern. As progress goes on for several years and households income and consumption grows, new demands arise, and in the region social inclusion and fairness is top in the agenda. How to proceed in this area? It is possible to ignore high inequality, and arrive late to tackle it. The risk of populism and derailment of good macroeconomics is high, with the negative consequences for all the population. But, the promise of quick fixes is not possible, and again it may lead to bad policies. Since social policies need financing, beyond rationalizing public expenditure, taxes may need to be increased, which is costly for the economy. But not addressing these issues in time is just a postponement of more drastic and costly policies. The road

Figure 15: Evolution of income inequality (Gini coefficients)



Source: World Bank, Development Research Group.
http://iresearch.worldbank.org/PovcalNet/index.htm

is not easy, it affects vested interest, but without social inclusion it is very difficult for the region to sustain growth. This is the stage in which Chile is now, and we can learn from virtues and errors of recent reforms.

Final remarks

Many countries in Latin America have made significant progress in terms of macroeconomic policies. All LAC7 countries averaged two-digit inflation during the 1980s. All of these countries, with the exception of Colombia, had episodes of three-digit inflation since 1970, and only in 1999 average inflation was below 10 percent. The conquest of inflation, through the establishment of sound monetary policies, organized around price stability, and the consolidation of fiscal policy are something relatively new in the region.

Of course, there are problems to solve in some countries, as those pointed out in Brazil, but the orders of magnitude of those adjustments are negligible compared to the imbalances of the past, when several economies went through the process of hyperinflation. Perhaps the most difficult task lies outside macroeconomic policies, which must be strengthened around stability and sustainability. This task is related to the need to improve institutions and it is essential to spur productivity growth.

On the macroeconomic front, letting the exchange rate float and allowing it to act as a shock absorber is key to navigate in a more integrated global economy, and this has been a great achievement in the region. Still some tensions may lie ahead as the US starts withdrawing its unprecedented monetary stimulus. LAC5 economies are well prepared to face significant currency adjustments. The share of public debt denominated in dollars is small, and financial systems are resilient to currency fluctuations. The experience during the global financial crisis shows the benefits of floating.

Among the large countries in the region, Argentina and Venezuela are at the other extreme. I have not gone into details on these two countries, most of all because they are much behind the rest of the region in terms of policies and institutions. They suffer from the historical macroeconomic instability that was central to Latin American stagnation, and they are the countries that abused the most the commodity price boom, especially Venezuela. Double

digit inflation, the collapse of the Venezuelan economy and the problems of recession in Argentina are clear reminders of the costs of not adopting sound macroeconomic policies. It is unfortunate that these lessons have been learnt at the cost of the wellbeing of so many people.

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